# LYNCHBURG CITY COUNCIL
## Agenda Item Summary

MEETING DATE: **September 30, 2003** AGENDA ITEM NO.: 6

CONSENT: REGULAR: **X** CLOSED SESSION: (Confidential)

ACTION: **X** INFORMATION:

ITEM TITLE: **Refinancing Combined Sewer Overflow (CSO) Program Virginia Revolving Loan Fund (VRLF) Loans**

RECOMMENDATION: Formally request the State Water Control Board (SWCB) to refinance existing and future VRLF loans from 20 year to 30 year repayment terms.

SUMMARY: Staff has held discussions with representatives from the Department of Environmental Quality (DEQ) about the long term health of the CSO Program and the financial position of the City's Sewer Operating Fund. DEQ developed an idea to refinance the City's existing CSO Virginia Revolving Loan Fund (VRLF) loans and to provide future loans with a 30 year amortization rather than the current 20 year repayment term. A financial analysis was performed by PJ Sun Financial Consulting, the City's utility rate consultant, to assess the impact upon the CSO program and the financial position of the Sewer Operating Fund if the City was able to utilize a 30 year amortization on existing and future VRLF debt. The results of the financial analysis indicated that, with a projected sewer rate increase of 3 percent per year, additional debt capacity of $26 million over six years would be created to fund more CSO projects. With the additional debt capacity, the City could potentially close an additional four overflow points and separate an additional 8.5 million square feet of combined area. Further, it is projected that with the refinancing, the two key Sewer Fund financial ratios, debt coverage and fund balance, would be at more manageable levels and the Sewer Fund would be better able to sustain unforeseen changes in revenues and expenditures between annual rate changes.

There have been substantial discussions with DEQ about its support of this refinancing plan. One point of disagreement has been DEQ staff requests that the City "modify" the CSO Special Order provision of using 9 hcf (hundred cubic feet) of average daily flow in each residence to calculate the required parameter that "sewer rates are to be equal or exceed 1.25% of median household income". DEQ staff has requested that the City use 7 hcf in the calculation. This requirement, if accepted, would require sewer rate increases of at least 4% per year over the next five years for the City to meet the 1.25% parameter. DEQ feels that 7 hcf is a more realistic average daily residential use figure. City staff prefers not to modify the special order but understands the substantial benefit to be gained from the refinancing. Discussions on this matter will continue.

PRIOR ACTION(S): July 1, 2003 – Finance Committee discussion

FISCAL IMPACT: If refinancing is approved, a substantial increase in Sewer Capital Projects Plan borrowing and new appropriations will be required for FY 2004-2009. If the SWCB approves the plan during its meeting in December 2003, City staff would submit a revised Sewer CIP request for approval and appropriation in early 2004. All project costs have been projected from the Sewer Fund with no additional impact to the City General Fund.

CONTACT(S): Greg Poff, CSO Program Manager, 847-1322, ext. 111
Bruce McNabb, Director of Public Works, 847-1362, ext. 268
Michael W Hill, Director of Financial Services, 847-1595 ext. 293

ATTACHMENT(S): PJ Sun Financial Report, Maps of additional CSO project areas

REVIEWED BY: lkp

Resolution:

BE IT RESOLVED That the City Manager, L. Kimball Payne, III, is authorized to request, from the Virginia State Water Control Board and the Department of Environmental Quality, refinancing of existing and future debt on CSO Virginia Revolving Loan Fund (VRLF) loans from a 20 year amortization to a 30 year amortization.

Adopted:

Certified: ______________________
Clerk of Council

164L

*PJ Sun LLC*
*405 Druid Hill Road*
*Vienna, Virginia 22180*

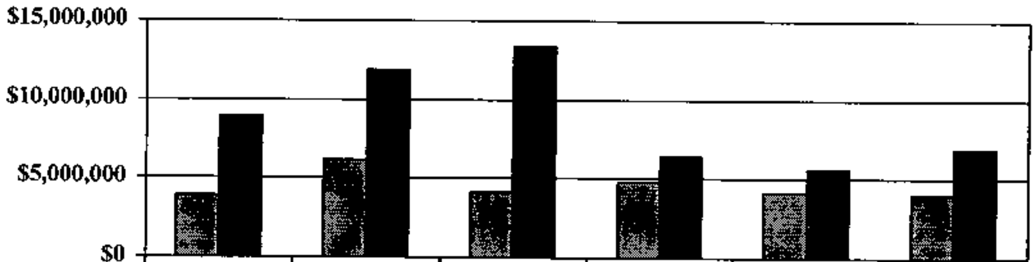
September 17, 2003

Mr. Tim Mitchell
City of Lynchburg Utilities
525 Taylor Street
Lynchburg, Virginia

Dear Mr. Mitchell:

This report has been prepared to describe the results of our analysis related to a potential restructuring of Virginia Revolving Loan Fund (VRLF) debts issued by the City. It is our understanding that the Department of Environmental Quality (DEQ) may agree to restructure all of the existing VRLF debts from 20 to 30 year repayment terms. Further, DEQ may also agree to issue future VRLF loans based on 30 year repayment terms.

This debt restructuring would allow the City to fund approximately $26.1 million more in Combined Sewer Overflow (CSO) and other water quality projects over the next six years without any additional rate increases over what is needed to fund the current CIP. As shown below, most of the increased funding would be used to accelerate CIP projects in the next three years.




| | FY 2004 | FY 2005 | FY 2006 | FY 2007 | FY 2008 | FY 2009 |
|---|---|---|---|---|---|---|
| **Currnt CIP** | **3,885,000** | **6,225,000** | **4,100,000** | **4,750,000** | **4,150,000** | **4,050,000** |
| **Potential CIP** | **9,000,000** | **11,800,000** | **13,400,000** | **6,450,000** | **5,700,000** | **6,900,000** |

Copies of the current and potential capital improvement programs are included as Exhibit I to this letter. The only difference between the two CIP's is that the potential CIP includes more funding for CSO sewer separation and rehabilitation projects.

Financial Impact

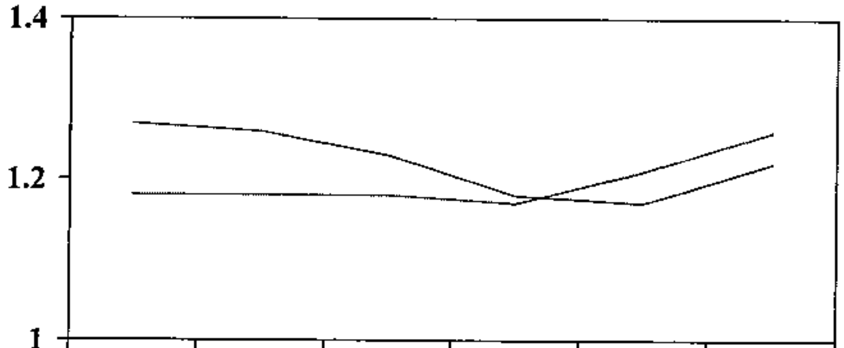
In order to estimate the amount of additional capital program work that could be funded as a result of the potential debt restructuring, we updated the Sewer Fund financial projections that were prepared as part of the last rate study. Summary financial projections based on 20 and 30 year VRLF repayment terms are attached as Exhibit II.

The updated financial projections reflect (1) a $510,000 annual revenue loss caused by Rock Tenn's planned reduction in sewer use, (2) new requirements to annually clean the James River Interceptor estimated at $800,000 in FY 2004 and $200,000 per year thereafter, and (3) further reductions in revenues due to likely requirements to provide sewer allowances for customers that use cooling water that is not discharged into the sewer system.

The updated financial projections are based on an 8% rate increase effective July 1, 2004 and 3% annual rate increases thereafter. The 8% increase is needed to make up for the revenue losses mentioned above and the new requirement to clean the James River Interceptor.

As you know, we have been concerned for the last few years about the debt coverage ratio in the Sewer Fund. The current minimum debt coverage ratio set by Council is 1.2 and the bond indenture requirement is 1.15. The current projections indicated that the Sewer Fund barely meets the 1.15 coverage requirement and is consistently below Council's 1.2 coverage requirement.

As shown below, if the VRLF debt can be restructured based on 30 year repayment terms, the debt coverage ratio can be improved even with more debt being issued and reducing the rate increase needed July 1, 2004 from 8% to 3%.




| | FY 2004 | FY 2005 | FY 2006 | FY 2007 | FY 2008 | FY 2009 |
|---|---|---|---|---|---|---|
| —— 20 year terms | 1.18 | 1.18 | 1.18 | 1.17 | 1.21 | 1.26 |
| —— 30 year terms | 1.27 | 1.26 | 1.23 | 1.18 | 1.17 | 1.22 |

The debt coverage improves because the debt service on existing VRLF loans will be reduced by approximately $470,000 in FY 2004 and $1.0 million annually thereafter if the repayment terms are restructured from 20 to 30 years. The debt coverage based on the 30 year repayment scenario decreases year by year as more new debt is issued. The immediate increase in debt coverage should provide the City with an opportunity to plan future activities and avoid the poor financial results it has been experiencing in the Sewer Fund. We believe this will be viewed positively by the bond rating agencies.

Extending repayment terms normally results in more interest to the borrower and is often discouraged for that reason. However, in this case the VRLF loans are zero percent loans, so the City will pay no additional interest and will effectively repay the loans with cheaper dollars due to the future impact of inflation.

Potential New DEQ Requirements

The Special Order with DEQ requires the City to annually adjust its sewer rates so that the annual sewer bill for a customer with 9 hcf (hundred cubic feet) of monthly use equals or exceeds 1.25% of MHI (Median Household Income). The City has met this test since FY 1998 and the current annual sewer bill is estimated to be 1.45% of MHI.

DEQ has expressed concern about using 9 hcf as the basis for determining compliance with the 1.25% test, even though it agreed to this monthly use amount as part of the Special Order. DEQ's staff has made it quite clear that the will not recommend the debt restructuring unless the City agrees to revise the Special Order so that a customer with 7 hcf, not 9 hcf, of monthly use equals or exceeds 1.25% of MHI.

A comparison of the 1.25% MHI test based on 9 hcf and 7 hcf is shown below:

| | @ 9 hcf | @ 7 hcf |
|---|---|---|
| Annual Sewer Bill: | | |
| Sewer rate | $4.42 | $4.42 |
| Avg. monthly use | x 9 | x 7 |
| Volume charge | 39.78 | 30.94 |
| Meter charge | 1.85 | 1.85 |
| Monthly sewer bill | 41.63 | 32.79 |
| | x12 | X12 |
| Annual sewer bill | $499.56 | $393.48 |
| | | |
| MHI Calculation: | | |
| 2000 MHI per US census | $32,234 | $32,234 |
| 75% of increase in CPI from 1999 | x1.068 | X1.068 |
| Est. MHI at July 1, 2003 | $34,426 | $34,426 |
| | | |
| Annual bill as a % of MHI | 1.45% | 1.14% |

DEQ has indicated that they would most likely allow the City five years to catch-up to the 1.25% requirement. As detailed in Exhibit III, the annual sewer bill could be at 1.25%

within five years assuming 7 hcf of monthly use, a 2% annual increase in CPI and 4% annual increases in the sewer rate.

It is important to note that the City's annual sewer bill at 5,000 gallons per month (6.68 hcf) is currently one of the highest in the State and significantly higher than the three surrounding jurisdictions. Based on the last available rate survey sponsored by The Virginia Municipal League (VML), only three communities out of 54 surveyed that had more than 1,000 customers had a sewer bill higher than Lynchburg. Further, the City's sewer bill at 5,000 gallons per month is higher than all of the participants that make up the First Virginia Cities except Richmond. Details of the rate and bill comparisons are included in Exhibit IV.

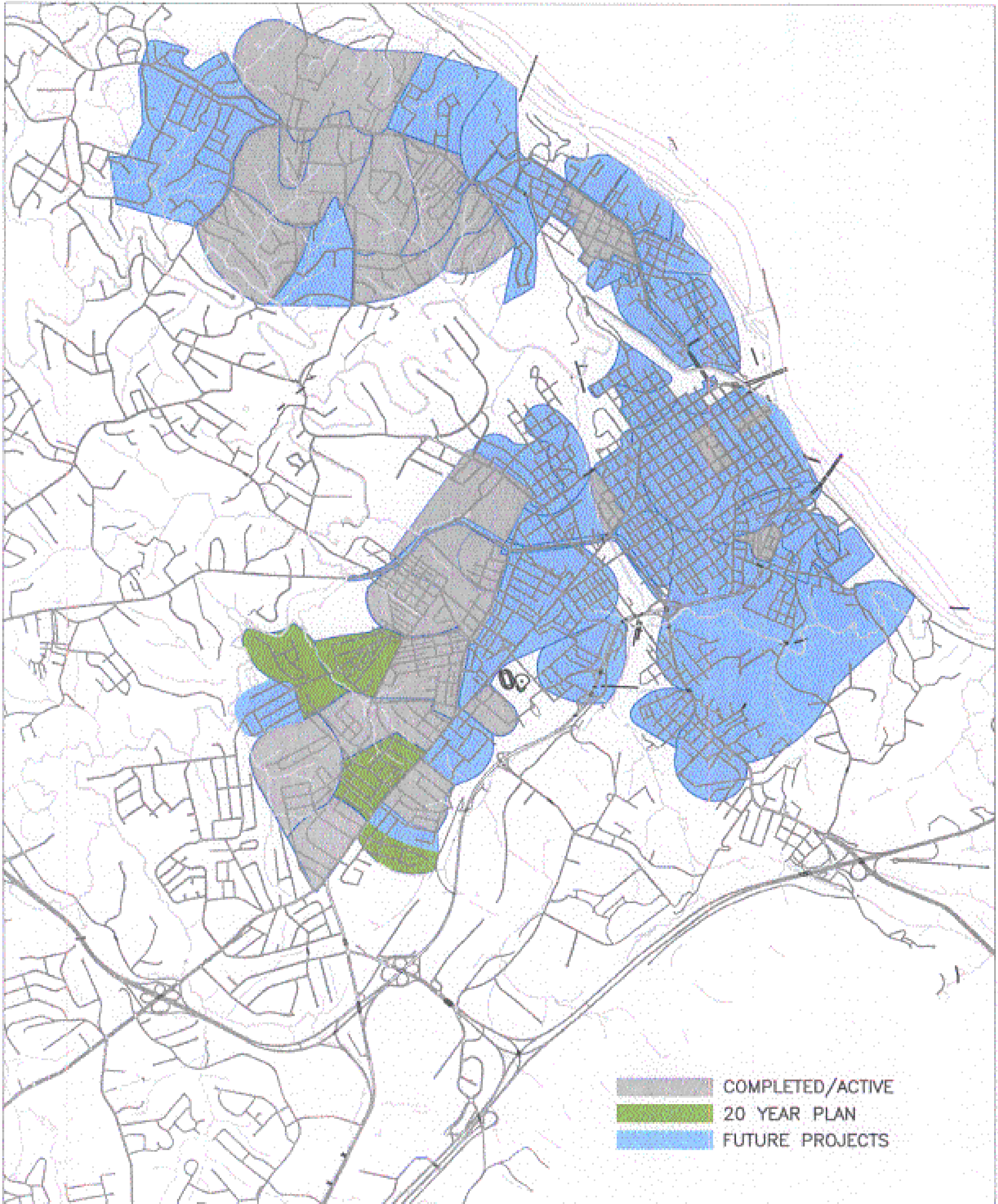
It is also important to note that some of the communities in the rate survey have sewer block rates that benefit large customers and help promote economic development. The Special Order required the City to phase out its sewer block rate structure several years ago. If the City continues to increase its sewer rates, it may find itself in a competitive disadvantage to attract new business and some existing customers may continue to find methods to reduce sewer use. If DEQ insists on revising the monthly sewer use from 9 hcf to 7 hcf to determine compliance with the 1.25% MHI criteria, the City may want to request a change in the Special Order to allow for sewer block rates.

XXXX

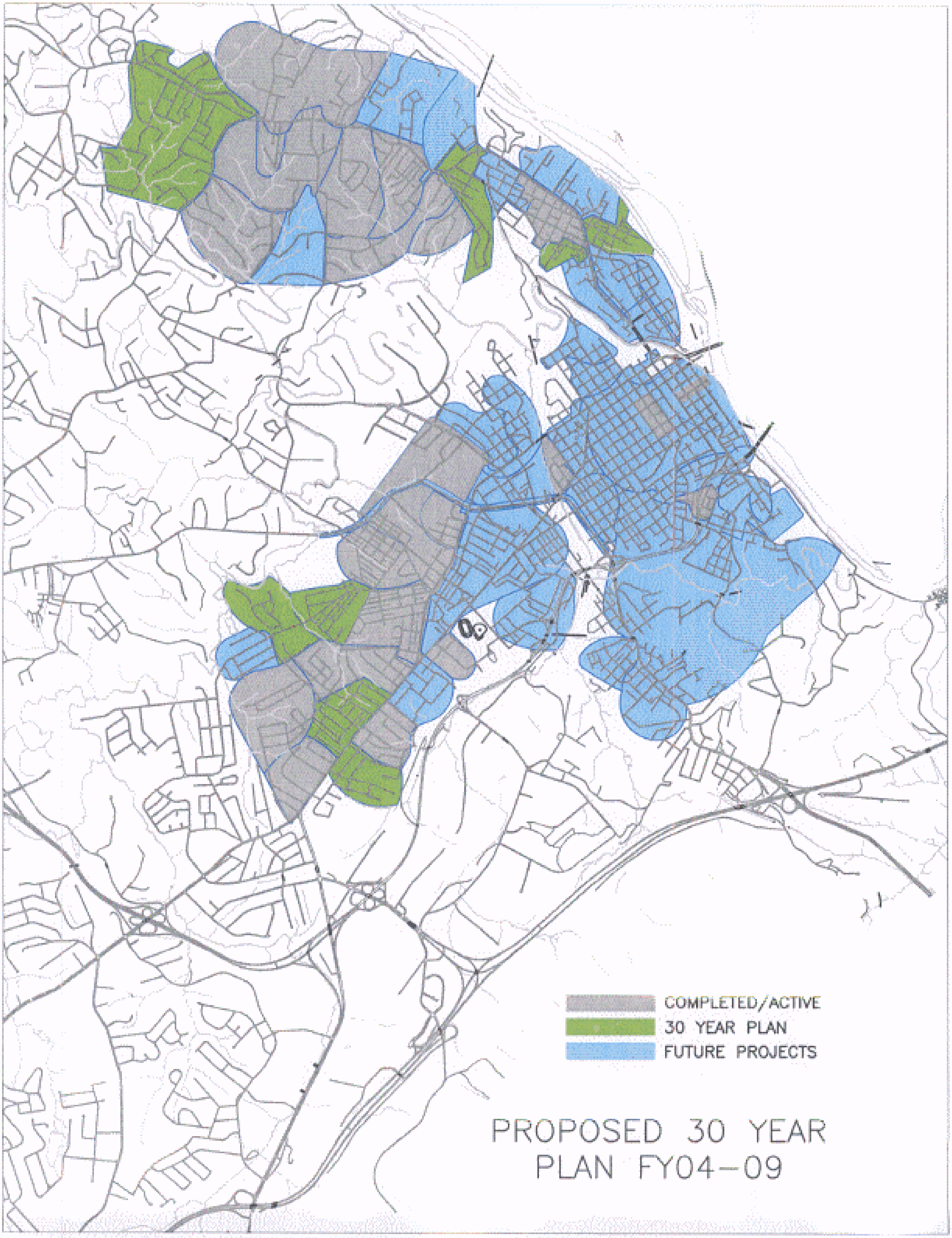
We understand that the City will be meeting with DEQ to further discuss their offer to restructure the VRLF debt and any conditions they may have related to the Special Order. We hope the information contained in this report will be helpful for this purpose. We would be happy to participate in the meeting if you wish. In the meantime, please call me if you have any questions or need additional information.

Regards,

Paul J. Cumiskey




20 YEAR PLAN
ADOPTED FY04-09 CIP




PROPOSED 30 YEAR PLAN FY04-09